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IN THE

Supreme Court of the United States

October Term, 1974

No. 74-448

AL A. MARTH, as Trustee in Bankruptcy of Pete Horner Excavating, Inc., an Arizona Corporation,

Petitioner.

v.

MARTHA MAYTAG DANNERBECK, and OSCAR C. PALMER, Sr., and CORINNE E. PALMER, his wife,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEAL FOR THE NINTH CIRCUIT

HUGHES & HUGHES, P.C.
By John C. Hughes
411 North Central Avenue
Phoenix, Arizona 85004
(602) 252-8001
Attorneys for Petitioner

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PETITION FOR WRIT OF CERTIORARI

The petitioner, Al A. Marth, as Trustee in Bankruptcy of Pete Horner Excavating, Inc., an Arizona corporation, respectfully prays that a Writ of Certiorari issue to review the decision of the Court of Appeals for the Ninth Circuit filed July 17, 1974, reharding denied August 12, 1974.

OPINIONS BELOW:

The opinion of the District Court was not reported but is included in the Appendix, *infra*, page 1a. The opinion of the Ninth Circuit Court of Appeals affirming the District Court is reported at _____F.2d_____ and is included in the Appendix, page 10a.

JURISDICTION:

The Judgment of the Court of Appeals for the Ninth Circuit was entered on July 17, 1974. A Petition for Rehearing was denied by order dated August 12, 1974. This Petition is filed within 90 days from the denial of the Motion for Rehearing. This Court has jurisdiction under 28 U.S.C. 1254 (1).

STATUTES AND RULES:

1. Article 3 § 2 of the Constitution providing in material part:

> "The judicial power shall extend to all cases . . .between citizens of different states. . ."

2. 28 U.S.C. 1332:

> "The district courts shall have original jurisdiction of all civil actions. . .between
> 1. Citizens of different states."

QUESTIONS PRESENTED:

1. May a party litigant invoke the jurisdiction of the Federal District Court by improperly filing her lawsuit in the names of third parties thereby creating diversity of citizenship when none in fact existed?

2. Does the bankruptcy court have exclusive jurisdiction to decide in the first instance whether it has actual or

constructive possession of property in which the Bankrupt has an interest?

3. Is the wife of a stockholder/officer and director of a closely held corporation (two stockholders) entitled to be subrogated to the rights of a surety when her community assumes the obligations of the surety and she uses her separate assets to fund a community trust account with which to discharge joint and several community liabilities.

4. If a grossly undercapitalized corporation secures financing and bonding by the use of the name, financial statements and property of the wife of a stockholder/corporate director, is such a person to be regarded as a principal in the corporation or an innocent third party?

5. Does a Trustee in bankruptcy have a continuing interest in proceeds of contracts when such contracts are completed with the use of funds from a community joint trust account established with the separate estate of the wife of a stockholder/corporate director?

6. Where at the time of bankruptcy a condition precedent to an obligation has not been fulfilled, can a creditor elect to waive such conditions precedent and recover from assets which would belong to the bankrupt?

STATEMENT OF THE CASE:

In October, 1963, Jon L. Dannerbeck, husband of the respondent Martha Dannerbeck entered into a partnership with Pete Horner. At that time, the business being conducted was very small "just strictly rental, hourly rental, digging foundations for houses and digging ditches for utilities." (deposition of Horner, p. 7/8). In April, 1964, they incorporated and became Pete Horner Excavating, Inc., an Arizona corporation. Horner's contribution to capital was two pieces of equipment which he valued at $12,000 to

$14,000. Dannerbeck's contribution was $6,000, which Mrs. Dannerbeck had deposited into the community bank account and upon which a check was drawn. In the corporation, Horner was President/Treasurer and Dannerbeck was Vice President/Secretary. There was no further infusion of equity capital. The corporate business was that of general contracting. To secure operating monies, credit and bonding, Mr. and Mrs. Dannerbeck and Horner executed numerous continuing guarantees and indemnity agreements. (fn. 1) As security for the continuing guaranties to the banks, Mrs. Dannerbeck pledged 2,000 shares of Maytag stock in return for which she was to have received an assignment of all of the stock in the bankrupt corporation. (R. Vol. 3, p. 789). The importance of Mrs. Dannerbeck's role is best indicated by the records of the banks and surety companies. Typically, *"I realize of course, that the wife of the Vice-President of*

(fn. 1)

(1) First National Bank of Arizona, May 1964, continuing guaranty dated November 1964 (Records of First National Bank (R. Vol. 3, p. 789). A loan of $40,000 was made under this guaranty for which Mrs. Dannerbeck pledged 2,000 shares of stock as collateral security (Letter of Francis C. Miller, November 9, 1964, records of First National Bank (R. Vol. 3, p. 789).

(2) Continental National Bank - continuing guaranty dated January 1965 for $150,000 (R. Vol. 4, p. 908) and February 3, 1965 - $300,000 (R. Vol. 4, p. 909). Again there was a collateral pledge of 2,000 shares of Mrs. Dannerbeck's stock (deposition of Mrs. Dannerbeck, p. 3).

(3) General Indemnity Agreement to USF&G dated August 11, 1964 (R. Vol. 2, p. 425).

(4) General Indemnity Agreement to National Union dated June 1, 1965 (R. Vol. 7, p. 1587).

(5) Continuing guaranty - Standard Oil Company (deposition of Mr. Dannerbeck, p. 65/66).

(6) Brunell Leasing Corporation, Continuing Guaranty (deposition of Mr. Dannerbeck, p. 65).

(7) Arizona Sand and Rock Company, guaranty of indebtedness, dated August 31, 1965 (deposition of Mrs. Dannerbeck, p. 40).

the principal firm has extremely substantial assets (Records of National Union, R. Vol. 3, p. 627), and, "*We are enclosing herewith the collateral receipt No. 31104 for 2,000 shares of the Maytag Company registered in the name of Martha Maytag Dannerbeck. We are most grateful for the assistance in this regard.*" (Letter from First National Bank to Francis Miller) (R. Vol. 3, p. 789 *et seq.*).

In July, 1966, the corporation was adjudicated bankrupt. Claims were filed by priority creditors in the sum of $12,780.00, by unsecured general creditors in the sum of $200,429.00, by the Dannerbecks in the sum of $163,167.00 and as contingent creditors, in the sum of $405,691.00 and by the Palmers in the amount of $479,000.00.

At the time of the bankruptcy, the corporation was engaged in six improvement district contracts. Arizona law requires contractors on such projects to be bonded. One bond conditioned upon the faithful performance of the contract and a second for the benefit of laborers and materialmen. To secure these surety bonds, Mrs. Dannerbeck, along with her husband and Pete Horner, as principals having a warranted interest in the subject matter of the contracts for which the surety bonds were being issued, executed joint and several indemnity agreements in favor of the surety companies. Four of the improvement district contracts were bonded by United States Fidelity and Guaranty Co., a Maryland corporation, (hereinafter USF&G) and two by National Union Fire Insurance Co. of Pittsburgh, a Pennsylvania corporation, (hereinafter National Union). In the indemnity agreements with National Union, Mrs. Dannerbeck and her co-indemnitors covenanted

> ". . .and the suretyship hereby applied for shall be construed as being for the special benefit of each of

> the undersigned and each represents that he or it is specifically or beneficially interest therein. . ."

and with USF&G

> ". . .the said surety is willing to accept this agreement upon the faith of the express warranty made by the Undersigned and incorporated herein that the Undersigned has such an interest in the execution of such bonds and obligations as to empower the undersigned to make this indemnity agreement."

Mrs. Dannerbeck testified that her purpose in executing the agreements was "to assist Jack in getting along in the business he was in. . .".

Following the declaration of bankruptcy, Mr. and Mrs. Dannerbeck voluntarily established a joint trust account with their attorney. As the various claims covered by the bonds were settled, checks were drawn on the joint trust account by the Dannerbecks' attorney and were sent to the surety companies. The surety companies in turn issued their checks in the same amount to the claimants.

Thereafter, two complaints were filed in the United States District Court for the State of Arizona. Named as plaintiffs were USF&G and National Union respectively. Named as defendants were your petitioner, the respondents, Palmer, who were purportedly purchasing the bonds that were to be issued by the improvement district and the Arizona municipalities of Phoenix, Prescott and Scottsdale.

The jurisdiction of the District Court was based upon the allegation that diversity of citizenship existed in that National Union was a Pennsylvania corporation, and USF&G was a Maryland corporation, with all defendants in the respective lawsuits being Arizona residents and/or municipalities. The relief prayed for in each action was a declaratory

judgment that the plaintiffs were entitled to receive the proceeds of the six city improvement district contracts. In the belief that the surety companies had in fact made the payments under the bonds, the Bankruptcy Court had given its consent for the Trustee to be sued. The Trustee filed his answer admitting the superior rights of the surety companies but alleged by way of cross claim against the Palmers that the balance of the proceeds were assets of the bankrupt's estate. The Palmers answered, counterclaimed and cross claimed that they were entitled to superior rights by virtue of assignments on the various contracts which the bankrupt had executed in their favor. Mr. Palmer made claim to the bonds based upon letter agreements which in each instance contained conditions precedent to his obligation to purchase the bonds. Typical of the provisions in the agreement was the following.

> "If for any reason these bonds are not promptly issued in the regular manner, and the job completed in average time required for this size of job, you are to promptly refund the amount we have then advanced to you upon written demand."

The bankrupt signed its acceptance on the letter agreements and executed an assignment of the proceeds which were lodged with the various cities. It was his contention that the agreements and assignments gave him superior rights to the proceeds of the contracts.

The true facts as to the Dannerbecks were revealed when in response to the interrogatories, the original plaintiffs stated they had received funds from Jon *and* Martha Dannerbeck on the same dates as the payments were made by them and that their actions were being prosecuted under an express trust on behalf of both the Dannerbecks (R. Vol. 4, p. 1556).

The answer to the interrogatory read

> "Subsequent to the filing of this action, National Union has from time to time received from *Jon and Martha Dannerbeck* funds totaling $246,268.22 claimed by National Union in this action. The payments by *the Dannerbecks* to National Union were made approximately on the same dates as the payments by National Union to the creditors of Pete Horner Excavating and to the contractors completing the Project No. 631119 (I.D.) as set forth in the foregoing answers. The payments were allocated to the particular performance and/or payment bonds under which National Union made payments to the aforesaid creditors and the completing contractor. National Union is now prosecuting this action under an express trust for and on behalf of the Dannerbecks whose payments to National Union were made pursuant to the general indemnity agreement of June 1, 1965 and National Union's right of exoneration."

Objections to the party plaintiffs, who had diversity of citizenship, were filed together with a motion to dismiss which resulted in Mrs. Dannerbeck being substituted as plaintiff in place of the surety companies. A second amended Complaint was thereafter filed in which Mrs. Dannerbeck alleged that she was entitled to subrogation, an equitable lien and assignment rights of the original plaintiffs. Amended answers, counterclaims and crossclaims were filed. The trustee specifically denied Mrs. Dannerbeck's right to be subrogated and alleged in the counterclaim and cross claim against the Palmers that the proceeds of the contract were the property of the Trustee under the Bankruptcy Act. The actions were consolidated and, following motions for summary judgment being filed by all parties and the raising of the jurisdictional question in open court, the trial court rendered an opinion finding in favor of Mrs. Dannerbeck for all monies paid under the indemnity agreements and in favor of

Mr. and Mrs. Palmer for the balance. The claims of the Trustee for the monies were summarily dismissed by the trial court by way of footnote.

> "Defendant Marth's contention is disposed *of by the case of Pearlman v. Reliance Insurance Company,* 371 U.S. 132, 83 S. Ct. 232. See also *In Re Dutcher Construction Corp.,* 378 F.2d 866 (2nd Cir. 1967). Defendant Marth's most recent motion to remand to the bankruptcy court is denied."

The municipalities discharged their obligations by payment and delivery of the bonds into the custody of the Court and have no further interest.

A timely appeal to the Ninth Circuit Court of Appeals was filed by the petitioner, it being his contention that the mere $20,000 capital contribution to the corporation and for the type of projects in which it engaged, caused it to be grossly undercapitalized; that the use of the Dannerbeck name, financial statements and pledge of stock to secure financing and bonding was therefore a contribution to capital; that it was the power of the Dannerbeck name and property that allowed the massive indebtedness of in excess of $1,000,000 to occur against the minimal financing; that the charade of the surety companies paying the claims under the surety bonds was without legal significance in that the use of the joint trust account showed the Dannerbecks to be discharging a community obligation and to be acting as principals in fact on the construction contracts, that being principals they were not a surety and were not entitled to subrogation; that there was no true diversity of citizenship to give the District Court jurisdiction and that jurisdiction properly lay in the bankruptcy court.

The appellate court found the Trustee's argument "rather persuasive" but nevertheless affirmed on the basis that Mrs.

Dannerbeck was not an officer or director of the corporation, that the proceeds from the improvement district contracts had never been a part of the bankrupt estate; that it was never established that the bankrupt's failure was due to undercapitalization; that there was no true distinction between the surety companies paying the claims as against Mrs. Dannerbeck; that there was no obligation on Mrs. Dannerbeck to seek contribution from her co-indemnitors notwithstanding that Pete Horner had visited the Dannerbecks in 1968 and offered to pay them what he owed them and that he had funds with which this could be accomplished.

ARGUMENT

We believe that the decision of the Ninth Circuit in this case has created a dangerous precedent and if allowed to stand can only lead to uncertainty and confusion in that:

(a) it allows the filing of a lawsuit in the names of third parties to provide a basis for diversity jurisdiction in the District Court.;

(b) it allows the consent of the Bankruptcy Court to to the Trustee being sued in a plenary action to be secured by third parties, and to carry over for the benefit of the real party in interest, notwithstanding the non-disclosure that the real party in interest is also the wife of an officer and director of the bankrupt, a closely held corporation;

(c) it approves the use of the name, financial statements and property of the wife of an officer and director of a closely held corporation as being a substitute for equity capital and as a method of avoiding the ordinary financial risk of a business enterprise;

(d) it refuses to recognize the settlement of corporate and community obligations by one spouse as being the act of a principal in a bankrupt closely held corporation.

(e) it allows subrogation to the wife of an officer and director of a bankrupt closely held corporation to the detriment of the general creditors.

We believe that the questions raised in this case are substantial and, in view of the conflict of the decision of the Ninth Circuit with the decisions of this Court and the Circuit Courts, under similar fact situations, justify the issue of the Writ of Certiorari.

Jurisdiction

Article 3, Section 2 of the Constitution provides in material part:

> "The judicial power shall extend to all cases in law and equity . . . between citizens of different states".

A provision implemented by 28 U.S.C. 1332:

> "a. The district courts shall have original jurisdiction of all civil actions where the matter in controversy exceeds the sum or value of $10,000 exclusive of interest and costs, and is between: 1) citizens of different states."

It is fundamental that the jurisdiction of the federal district courts springs wholly from the Constitution and cannot be conferred by consent or stipulation. *California v. Larue*, 93 S. Ct. 390, 409 U.S. 109, 34 L. Ed. 2d 342, *Rehearing denied*, 93 S. Ct. 1351, 410 U.S. 948, 35 L. Ed. 2d 615, *Bankman v. Sanford*, 162 F.2d 592, *cert. denied*, 68 S. Ct. 155, 332 U.S. 816, 92 L. Ed. 393, *Iselin v. LaCosta*, 141 F.2d 791.

In this case, true diversity of citizenship did not exist. The original plaintiffs; *i.e.*, two surety companies were used merely as a facade. They were never real parties in interest. It was the Dannerbecks' money that was used in settlement of the claims protected under the bonds. If, therefore, a right to bring a plenary suit existed, it was the Dannerbecks' right as disclosed in their interrogatories. Irrespective, Mrs. Dannerbeck was an Arizona resident; the defendants Palmer were Arizona residents; the bankrupt was an Arizona corporation and the remaining defendants Arizona municipalities. Diversity was clearly lacking and it was mandatory for the action to have been brought in the state court when the proper consent had been secured. See *Rockmore v. New Jersey Fidelity and Plate Glass Company*, (C.C.A. 2nd Cir.) 23 Am. B.R. (N.S.) 282, 65 F.2d 341; *Gorovitz v. Balkan*, 96 F. Supp. 747. The fact that the Trustee in Bankruptcy was a defendant in the case is totally immaterial in that there must exist grounds of federal jurisdiction apart from the connection of the controversy with a federal bankruptcy proceeding. (Collier Bankruptcy Manual, 2nd Ed. §23.09). For the purposes of determining whether required diversity of citizenship exists, courts will look to the citizenship of the real parties in interest and disregard citizenship of nominal parties having no real interest in the controversy. Mrs. Dannerbeck was a real party in interest and it follows that even if the purported plaintiffs had made true disclosure at the outset that they were suing under an express trust on behalf of both the Dannerbecks, the required jurisdiction would still not exist. Jurisdiction cannot be established by colorable or feigned allegations made solely for such purposes. *Emland Builders, Inc. v. Shea*, (10th Cir.), 359 F.2d 927. We submit that the lack of jurisdiction in the first instance

in this case is sufficient cause for this court to issue its Writ of Certiorari and summarily reverse the judgment.

Bankruptcy Jurisdiction:

The same duplicity, *i.e.*, the use of the surety companies was used by the Dannerbecks to secure the consent of the Bankruptcy Court to the Trustee being sued in a plenary action. Such consent was given in that it was apparent that the Trustee as against a surety would have no valid claims to the proceeds of the contracts in face of the decisions of this Court in *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132 (1962); *Henningsen v. U.S. Fidelity and Guaranty Co.*, 208 U.S. 404 (1908); *Prairie State Bank v. U.S.*, 164 U.S. 227. However, in proceeding as she did, the Dannerbecks thwarted the right of the Bankruptcy Court to decide in the first instance whether the proceeds were subject to its jurisdiction as being property in the actual or constructive possession of the bankrupt. *Taubel - Scott - Kitzmiller Co., Inc. v. Fox*, 264 U.S. 426, 2 Am.B.R. (N.S.) 912, 44 S. Ct. 396, 68 L. Ed. 770; *In Re Patrick*, 194 F.2d 750 (7th Cir. 1962). As held In the matter of Tax Services Association of Illinois, (Harris v. Avery Brundage Co.) 305 U.S. 160, 38 Am.B.R. (N.S.) 85, 59 S. Ct. 131, 83 L. Ed. 100. "In every controversy, the Bankruptcy Court has power in the first instance to determine if it has actual or constructive possession which is essential to its jurisdiction to proceed." The mere assertion of a claim adverse to a bankruptcy trustee does not oust the bankruptcy court of its jurisdiction, but it has both the power and the duty to examine claims to extent of ascertaining whether the claim is ingenuous and substantial. *Cline v. Kaplan*, 65 S. Ct. 155, 323 U.S. 97, 89 L. Ed. 97. And see *Pepper v. Litton*, 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281 where

this Court said as to the jurisdiction of the Bankruptcy Court that

> "Among the granted powers are the *allowance and disallowance of claims; the collection and distribution of the estates of bankrupts and the determination of controversies in relation thereto; the rejection in whole or in part* 'according to the equities of the case' of claims previously allowed; and the entering of such judgments 'as may be necessary for the enforcement of the provisions' of the act. *In such respects the jurisdiction of the bankruptcy court is exclusive of all other courts.*"

See also in *Katchen v. Landy*, 382 U.S. 323, 86 S. Ct. 467, 12 L. Ed. 2d 391.

We would respectfully submit that the lower court erred in failing to order that Mrs. Dannerbeck submit to the jurisdiction of the Bankruptcy Court when it was shown that she had avoided the exercise of such jurisdiction by subterfuge.

The argument used against the Trustee in this respect was simply that the Bankruptcy Act does not authorize a Trustee to distribute other people's property among the creditors of a bankrupt. However, Mrs. Dannerbeck was not "other peoples" in this case. Her financial statements and property had been the source of the fuel to the corporation to turn the wheels to secure financing and the surety bonds; she was the wife of a corporate officer and director and had a community property interest in the corporation. The bankrupt was hopelessly undercapitalized for the size and nature of its operations, a situation which existed by virtue of the financial status of Mrs. Dannerbeck being behind the guarantees and indemnity bonds. We submit that under such circumstances the payments under the bonds cannot be regarded other than as contribution to capital and her possession of the proceeds

was the possession of corporate property by a principal of the bankrupt corporation and therefore in the possession of the Bankrupt and subject to the jurisdiction of the Bankruptcy Court. See *Reifsnyder v. Levy and Son*, (3rd Cir.) 88 F.2d 287, *cert. denied*, 301 U.S. 696, 57 S. Ct. 926, 81 L. Ed. 1351; *Master v. Spencer*, (C.C.A. 8th Cir.) 29 Am. B. R. 246, 203 Fed. 210.

Pearlman, supra, gives the right of subrogation to sureties. Mrs. Dannerbeck was not a surety. She was an intrinsic part of the corporation without whom there could not have been the financing and bonding of the business operation. As pointed out by way of footnote in *Pearlman*

> "The right of subrogation is not founded on contract. *It is a creature of equity; is enforced solely for the purpose of accomplishing the ends of substantial justice*; and is independent of any contractual relations between the parties. . ."

Equity is not done when by the actions of one so intimately connected with the very structure of the corporation, she is not only allowed to make herself whole but also save her community and the other incorporators from loss at the expense of the general creditors.

Anticipating the argument that the proceeds never became a part of the bankrupt estate and that the Trustee therefore had no interest therein, we would respectfully urge to the Court that the law of bankruptcy is that "if certain claims are disallowed and a bankrupt would thereon become solvent, the bankrupt does have an interest". *Marks v. Brucker*, 434 F.2d 897 (9th Cir. 1972); *In Re Community Neighbors, Inc.*, 287 F.2d 572 (7th Cir. 1961). 3 *Collier on Bankruptcy*, 14th Edition, 57.17.

And, further, if by chance the available proceeds exceeded

the claims made on them, then it is fundamental that the balance of such proceeds would be a part of the estate and that therefore the Trustee cannot be denied an interest in such available proceeds.

The Trustee offers no argument with the principles set forth in *Pearlman, supra*, or related cases but we believe that there is a distinct and definite difference between a surety and a principal in a bankrupt corporation. Mrs. Dannerbeck is such a principal. She is not a surety. We would further submit that irrespective of whether it is a claim being made by a corporate officer or dominant stockholder against a bankrupt corporation, or a claim of title to property in a plenary action, the principles laid down by this Court in *Pepper v. Litton*, 308 U.S. 295, 60 S. Ct. 238, should apply. In allowing Mrs. Dannerbeck to be subrogated to the rights of a surety, *Pepper v. Litton, supra*, was ignored and we submit that a Writ of Certiorari is clearly warranted.

The Equitable Right of Subrogation:

The decision of the Ninth Circuit in this case establishes what we believe to be an extremely dangerous precedent. It is a decision which not only exalts from over substance but one which literally ignores the rigid standards which have been traditionally applied by this Court and the circuit courts in similar circumstances. (fn. 2) It will allow officers and dominant stockholders to evade the ordinary necessary

(fn. 2)

Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed 281; Twin Lick Oil Company v. Marking, 91 U.S. 587, 588, 23 L.Ed 328; Southern Pacific Co. v. Bogert, 250 U.S. 483, 39 S. Ct. 533, 68 L.Ed 1099; Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599, 41 S. Ct. 209, 65 L.Ed 425; Manufacturers Trust Co. v. Beaker, 338 U.S. 304, 311, 70 S.Ct. 127, 94 L.Ed 197; DeMet v. Harralson, 399 F2d 35 (5th Cir. 1968); Hopper v. American National Bank of Cheyenne, Wyoming, 309 F2d 35 (10th Cir. 1962); In re Trimble Company, 479 F2d 103 (3rd Cir. 1973); Braddy v. Randolph, 352 F2d 81; Alexander v. Thielman, 69 F2d 610.

risks involved in this type of business enterprise by the use of paper guarantees of their spouse rather than by the investment of equity capital.

Mrs. Dannerbeck had no contractual right of subrogation and it follows that her recovery must necessarily rely on equity. To deserve equity, she must do equity and the question is therefore, is she doing equity in shielding her co-indemnitors from the financial fiasco so that they and her community remain whole at the expense of the general creditors of the bankrupt. Mr. Horner had the means to pay on his indemnity agreement to his surety and, in fact, did offer to pay Mrs. Dannerbeck. Mrs. Dannerbeck relied instead on her recovery from the proceeds of the contract and so allowed Horner to go unscathed, untouched, and without a penny out of his pocket. Does this course of action give rise to an equitable right of subrogation? We submit that it does not; and that equity is to be regarded as a shield for the innocent rather than a sword for the guilty. What more compelling equity could there be in favor of your petitioner than the fact that the guilty are going free at the expense of the innocent general creditors?

How can the Dannerbeck community equitably be given subrogation rights as indemnitors for the sureties of the closeheld corporation? This bankrupt had but two stockholders. The Dannerbeck community and Horner. The Dannerbeck stock was purchased when Mrs. Dannerbeck contributed $6,000 to the community bank account belonging to herself and to her husband. Arizona is a community property state and the law is quite clear that irrespective of the original source of the funds, the fact that they were placed in a joint bank account and used for a community purpose raises the presumption that they became community

property. *Blaine v. Blaine,* 159 P.2d 786, 63 Ariz. 100. By what authority can Mrs. Dannerbeck be treated differently? Particularly, when the record shows so conclusively that she had been instrumental in securing financing for the corporation.

Irrespective of the source of the funds used in the settlement process, it was these same funds which had been shown in the joint financial statements which had been supplied to and upon which the banks and surety companies had relied in making the loans and surety bonds. The decision of the Appellate Court ignored that Mrs. Dannerbeck gave her personal warranty in each of the surety agreements and further ignored that it was her own personal stock which she pledged on the continuing guaranties to the banks on which operating capital was secured (R. Vol. 3, p. 789 *et seq.*). This is no innocent third party and we submit that it is highly significant that all of the stock of the bankrupt corporation was to be assigned to Mrs. Dannerbeck (R. Vol. 3, p. 789 *et seq.*). The finding of the Appellate Court

> "that she was not an officer or a director of the corporation nor was she even a minority stockholder"

we submit is untenable. Mrs. Dannerbeck was to hold all of the stock in the corporation in consideration of her guaranteeing the corporate loans. It was the use of her personal guarantee and assets that made possible the loans and the securing of the surety bonds. There is absolutely no distinguishing feature in her situation than that which existed in ***Braddy v. Randolph, supra.***

> "On this ridiculously small amount of capital, the bankrupt launched into extensive construction projects. . . The cost of some of the larger commercial projects ran into hundreds and thousands of dollars. . .

> The bankrupt borrowed heavily and consistently from the four officers and the North Carolina National Bank (hereinafter "Bank"). The money which the officers. . . loaned the bankrupt was normally acquired from the bank by use of their personal credit and personal assets. . . The Referee and Court could reasonably conclude that these loans were necessitated by the initial insufficiency of the bankrupt's equity capital and that the loans made by the officers were, in effect, contribution to capital. . . Rather than invest more capital, the officers and stockholders by the use of the borrowed funds substantially shifted and evaded the ordinary financial risks connected with this type of business enterprise. . ."

We believe that the words of this Court in *Pepper v. Litton, supra*, are particularly appropriate here.

> "No matter how technically legal each step in that scene may have been, once its basic nature was uncovered it was the duty of the bankruptcy court in the exercise of its equity jurisdiction to undo it. *Otherwise the fiduciary duties of dominant or management stockholders would go for naught; exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart*"

If equity demands that whoever put it in the power of another to do the wrong must bear the loss (*Wood v. Steele*, 73 U.S. 80, 82 (1867); *National Savings v. Cresswell*, 100 U.S. 630, 643 (1879); *Carpenter v. Longan*, 83 U.S. 278) then clearly Mrs. Dannerbeck was not entitled to equitable subrogation.

We would further point out that Mrs. Dannerbeck had no contructual subrogation under the terms of her indemnity contract to her surety. As a principal, she could not contract for subrogation in that the risk she undertakes is for her own benefit and she is not paid a premium for her indemnity. It

was her duty to pay and the right of subrogation will not lie in one whose duty it is to pay. Further, to allow subrogation to a principal of a bankrupt corporation is tantamount to allowing a bankrupt to prove against himself and pay himself at the expense of other creditors and so escape the ordinary financial risks of doing business on a large scale. *Rabinovitz v. Oughton,* 92 F.2d 297, cert. denied, 58 S. Ct. 746, 303 U.S. 649, 82 L. Ed. 1110, *Braddy v. Randolph,* 352 F.2d 80.

Giving Mrs. Dannerbeck the right of subrogation, under the circumstances detailed herein, is, we submit, inequitable, unfair and unjust and we submit that it is a decision which cries out for reversal.

The Palmers.

We believe that the jurisdictional questions previously discussed are equally applicable to the respondent Palmer. However, we would also submit that Mr. Palmer created conditions precedent to his obligation to purchase the bonds and the remedy in the event the conditions were not met, *i.e.*, "...you are to promptly refund the amount we have advanced to you...". Therefore, when at the time of bankruptcy there were no bonds in existence, he should properly have been precluded from making any claim other than as a general creditor.

The date of bankruptcy froze all rights and obligations of the bankrupt and vested them in the trustee. Assuming arguendo that *Pearlman, supra,* was properly applied to defeat the claim of the Trustee, on the basis that the Trustee could not acquire any rights to the funds or property not in existence at the time of the bankruptcy, how can the

claim of Palmer be justified. He was in no better position and, indeed, inasmuch as he was totally unable to show that the funds which he advanced to Horner were used in the improvement district contracts, his claim thereto should have been rejected. We submit that the documentation on which Palmer based his claim showed him to be a prospective purchaser rather than an assignee and his conditions not having been met he had no right to the bonds.

We accordingly submit that Mr. Palmer may properly prove in the bankruptcy court as a general creditor, but he had no right to a plenary action based upon a claimed right to bonds which were not in existence at the time of the bankruptcy.

CONCLUSION

The jurisdiction to bring up cases by certiorari from the Circuit Courts of Appeals was given for two purposes, first to secure uniformity of decision between those courts in the nine circuits, and second to bring up cases involving questions of importance which it is in the public interest to have decided by this Court of last resort. *Magnum v. Coty*, 262 U.S. 159. Either of such purposes justify certiorari in this case. The decision of the Ninth Circuit in distinguishing Mrs. Dannerbeck's position with the other dominant or managing stockholder cases was patently a creation of distinction without a difference. The conflict is real and embarrassing and not merely an inconsistency in dicta or in the application of general principles. It is a decision which can create the utmost confusion in Bankruptcy Courts and in the collection of bankrupt estates. Corporate assets will indeed be difficult to assemble if all that is required is for officers and directors

to say "You can't have that, it belongs to wife"! This decision will allow just that.

Mrs. Dannerbeck was wrong, very wrong, in invoking the jurisdiction of the district court and evading the jurisdiction of the Bankruptcy Court by the use of the Surety Companies. But, notwithstanding, she is allowed to prevail. She was wrong, very wrong, in allowing the use of her personal assets to stand behind the corporation and then claim to be an innocent third party. But, notwithstanding she is allowed to prevail. She was wrong, very wrong, in declining the offer of Horner in 1968 to make good. But she is allowed to prevail. Some monies could have been made available to the general creditors.

This is equitable? No, it is not, but it is just cause for the issue of a Writ of Certiorari.

We respectfully ask that this Court so order.
Respectfully submitted,
HUGHES & HUGHES, P.C.

By John C. Hughes
Attorneys for the Petitioner

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF ARIZONA

MARTHA MAYTAG DANNERBECK,
Plaintiff,

vs.

OSCAR C. PALMER, SR., and CORINNE E. PALMER, his wife; AL A. MARTH, Trustee in Bankruptcy of Pete Horner Excavating; CITY OF PHOENIX, a municipal corporation; and CITY OF PRESCOTT, a municipal corporation,
Defendants.

No. Civ-6055
-6056
Phx WEC
(Consolidated)

FILED
Sep 5 1972

OPINION

This is a diversity action originally brought by United States Fidelity and Guaranty Company seeking a declaration of various parties' rights in and to the proceeds of certain street improvement contracts. The matter in controversy exceeds $10,000. 28 U.S.C. §1332; 28 U.S.C. §2201. On November 25, 1968, Martha Maytag Dannerbeck was substituted as party plaintiff in this action. This did not invalidate federal jurisdiction. 3B J. Moore, *Federal Practice* ¶25.05.

The fund in question consists of street improvement bonds issued by the respective cities, A.R.S. §9-692 through §9-695, and cash paid by property owners pursuant to assessment and warrant, A.R.S. §9-686 and §9-687. The matter is before the Court on cross motions for summary judgment by all three of the interested parties.

Horner Excavating, Inc., was awarded street improvement contracts with the cities of Prescott (Project P-99) and Phoenix (Project P-64095), Arizona. The contracts were executed on April 15, 1965 and March 2, 1966 respectively.

United States Fidelity and Guaranty Co. issued payment and performance bonds on each project. On July 18, 1966, Horner Excavating, Inc., was adjudicated a bankrupt. At that time it had neither completed work nor paid all the laborers and materialmen on either project. The surety completed the work and paid the laborers and materialmen.

Plaintiff indemnified the surety and claims priority to the fund as subrogee of the surety's subrogation and assignment rights. Defendant Palmer claims priority based on assignment rights obtained by virtue of certain letter agreements and absolute assignments executed by Horner Excavating, Inc. Defendant Marth claims the proceeds as trustee in bankruptcy of Horner Excavating, Inc. Defendants City of Prescott and City of Phoenix claim no interest in the fund.[1]

I.

To the extent plaintiff indemnified the surety for the cost of completion, her rights to the fund are superior to those of the defaulting contractor's assignee. *Prairie State National Bank v. United States*, 164 U.S. 227, 17 S. Ct. 142 (1896).

As applied to the instant case, the surety had a right to resort to the securities and remedies the cities and/or the assessed homeowners were capable of asserting against Horner Excavating, Inc. This included the right to withhold the money and bonds and apply them to the cost of completion.

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[1] *Dannerbeck v. Palmer, et al.*, Civ. No. 6056 Phx WEC was consolidated with this case on December 21, 1970. That action presents similar issues with respect to six construction contracts entered into between Horner Excavating, Inc., and the cities of Phoenix and Scottsdale, Arizona. The Court is of the opinion that no material differences exist with respect to the legal and equitable issues presented. The instant opinion is equally applicable therein.

Horner Excavating, Inc., was entitled to none of the proceeds until completion and it failed to complete the projects.

II.

To the extent plaintiff indemnified the surety for the latter's payment of the laborers and materialmen, she is entitled to reimbursement from the fund in question. *Henningsen v. United States Fidelity and Guaranty Co.*, 208 U.S. 404, 410, 28 S. Ct. 389 (1908). See also, *Pearlman v. Reliance Insurance Company*, 371 U.S. 132, 83 S.Ct. 232 (1962); *Industrial Bank of Washington v. United States*, 424 F.2d 932 (D.C. Cir. 1970); *Reliance Insurance Co. v. Alaska State Housing Authority*, 323 F. Supp. 1370 (1971); *National Surety Corp. v. United States*, 133 F. Supp. 381 (Ct. Cl. 1955), cert. denied, 350 U.S. 902 (1955); *Royal Indemnity Co. v. United States*, 93 F. Supp. 891 (Ct. Cl. 1950); *Stroud Oil Reclaiming Co. v. Community State Bank of Bristow*, 475 P.2d 819 (Okla. 1970); 4 A. Corbin, *Contracts*, §901.

Defendant Palmer relies on *Adamson v. Paonessa*, 179 Pac. 880 (1919), in which the California Supreme Court construed street improvement statutes from which Arizona's were adopted.[2] See also *Guthrie Investments, Inc. v. Bennet*, 388 P.2d 955 (Wash. 1964); *State Bank of Albany v. Dan-Bar Contracting Co.*, 212 N.Y.S.2d 386 (1961), aff'd 187

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[2] There are no Arizona cases on point. In *Fidelity and Guaranty Co. v. California-Arizona Co.*, 21 Ariz. 172, 186 Pac. 502 (1920), the lower Court ruled in favor of the surety; however, the appeal was dismissed as to that issue by stipulation of the parties and the Supreme Court expressly withheld any opinion on the matter.

N.E.2d 19 (1962).

While California's interpretation of the statutes would ordinarily be entitled to great weight, this Court suggests that the Arizona Supreme Court would depart from the holding of *Adamson, supra*, and would adopt what is, in this Court's opinion, the better and majority rule. There is no suggestion in the legislative history that Arizona intended to adopt the *Adamson* rationale. Moreover, the California legislature statutorily overruled the decision immediately after it was handed down. Finally, the right the surety is subrogated to is not limited to retained percentages. It extends to any money due the contractor in the possession of the public body. See *Reliance Insurance Co. v. Alaska State Housing Authority, supra; Stroud Oil Reclaiming Co. v. Community State Bank of Bristow, supra; In re Dutcher Construction Corp.* 378 F.2d 866 (2d Cir. 1967) and cases cited therein.[3]

Defendant Palmer further argues that all of plaintiff's cases base a finding of subrogation in a surety on the right of the government contracting party which promises to pay the contractor to use the contract proceeds to pay unsatisfied laborers and materialmen if it should elect to do so. Frequently the cases do refer to the right of the government to pay laborers and materialmen. This is generally stated in

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[3] Arizona amended its statutes in 1969 to require a 100% payment bond rather than 50%. Defendant Palmer argues this is indicative that Arizona intended to protect laborers and materialmen that way rather than the lien method chosen by California. The weakness in this argument is twofold. First, there exists a fifty year interval between the two legislative actions, during which both states required a 50% bond. Second, the cases indicate that the provision for a payment bond is not inconsistent with the equitable priority theory. See, e.g., *Stroud Oil Reclaiming Co. v. Community State Bank of Bristow, supra.*

reference to a contractual obligation by the contractor vis-a-vis the government to pay laborers and materialmen, thus the non-payment would be a contractual default giving the government the right to pay. The cases, however, do not rely on this distinction. There is no discussion in *Henningsen, supra,* concerning the contractor's contractual obligation to pay laborers and materialmen.

> "Henningsen . . . entered into a contract with the United States to construct buildings. The guaranty company was surety on that contract. Its stipulation was not merely that the contractor should construct the buildings, but that he should pay promptly and in full all persons supplying labor and material in the prosecution of the work contracted for. He did not make this payment, and the guaranty company, as surety, was compelled to and did make the payment. Is its equity superior to that of one who simply loaned money to the contractor, to be by him used as he saw fit, either in the performance of his building contract or in any other way? We think it is."

208 U.S. at 410. See also *Stroud Oil Reclaiming Co. v. Community State Bank of Bristow, supra.*

In any event, in the instant case the contractor had a contractual obligation to pay laborers and materialmen. The relevant portions of the contracts are as follows:

> ". . .turn the said work over to the Superintendent of Streets, complete and ready for use free and discharged of all claims and demands whatsoever, for or on account of any and all labor and materials used or furnished to be used in said improvement."

> ". . .furnish all necessary materials and labor. . . [at his] own cost and expense."

These provisions read in conjunction with the statutorily required payment bond demonstrate that the contractor was obligated vis-a-vis the creditor to pay the laborers and materialmen. See *Martin v. National Surety Co.*, 300 U.S. 588, 57 S.Ct. 531 (1937). *Cf. Henningsen v. United States Fidelity and Guaranty Co., supra.*[4]

III.

The surety completed Project P-64095 at a cost of $49,629.25. The penalty amount of the performance bond was $17,460.45. There was no provision in the bond permitting the surety to complete the work in case of default. Defendant Palmer contends the surety was a volunteer with respect to the amount expended in excess of $17,460.45, and as such, is not entitled to subrogation. This Court disagrees.

The obvious purpose of the bond was to insure satisfactory performance of the project. The obligee of the bond, the City of Phoenix, made demand on the surety to complete the work pursuant to its bond obligation. Moreover, the surety had a right under the bond application to complete the work. See 83 C.J.S. *Subrogation* §9 at 601-607. *Cf. Mosher v. Conway*, 45 Ariz. 463, 46 P.2d 110 (1935). *A fortiori* defendant Palmer's argument with respect to Project P-99 is without merit.

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[4] Defendant Marth's contention is disposed of by the case of *Pearlman v. Reliance Insurance Company*, 371 U.S. 132, 83 S.Ct. 232 (1962). See also *In re Dutcher Construction Corp.*, 378 F.2d 866 (2d Cir. 1967). Defendant Marth's most recent motion to remand to the bankruptcy court is denied.

IV.

Subrogation is an equitable remedy. Both plaintiff and defendant Palmer assert superior equitable claims to the fund. Without going into the various equitable considerations advanced by the parties, this Court is of the opinion that the surety's position is stronger than that of the defaulting contractor's assignee. It satisfied the very obligation the fund was to accomplish, and in so doing, made the instant proceeds available. See *Henningsen v. United States Fidelity and Guaranty Co., supra; Prairie State National Bank v. United States, supra; National Shawmut Bank of Boston v. New Amsterdam Casualty Co.*, 411 F.2d 843 (1st Cir. 1969). For the same reason plaintiff, as indemnitor of the surety, is entitled to priority over defendant Palmer. See 83 C.J.S. *Subrogation* §62.

V.

Two other arguments are raised by defendant Palmer. He contends plaintiff has an adequate remedy at law which should preclude her from the equitable remedy of subrogation. It is argued that plaintiff has a legal right to require contribution from the co-indemnitors. The argument is without merit. The remedy at law must be clear, complete and adequate. Here it is not. Nor is it against the same party as to whom relief in equity is sought. See 30 C.J.S. *Equity* §25. See also 18 Am Jur 2d *Contribution* §2.

Finally, defendant Palmer contends that plaintiff is not entitled to subrogation with respect to amounts paid to Arizona Sand and Rock Co. This is based on the proposition that subrogation is not available to one who is primarily

liable for the debt. Plaintiff had executed a continuing guaranty of Horner Excavating, Inc., indebtedness to Arizona Sand and Rock Co. in 1965. This contention is also without merit. The liability of a guarantor is secondary rather than primary.[5]

VI.

The remaining issues concern the priority of certain assignments executed by Horner Excavating, Inc., in favor of the respective sureties and defendant Palmer. The Court concludes that defendant Palmer is entitled to priority in the remaining funds. His equity in this regard is intrinsically superior to that of the surety and, consequently, that of plaintiff. See 6 Am Jur 2d *Assignments* §113. This superiority is based on the same factors which permitted the surety to prevail on its subrogation claim, namely, that the money so advanced contributed to the availability of the instant proceeds. See Part IV, supra. Moreover, the facts and circumstances of the case favor such a result. These include *inter alia* the fact that defendant Palmer was unaware that the surety claimed assignment rights to the proceeds; the fact that the surety is charged with knowledge that improvement district contracts do not provide for progress payments; the fact that defendant Palmer gave notice to the cities of his assignment rights, and the fact that several of the contracts in question contained a provision permitting

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[5] A paying guarantor is subrogated to the rights the creditor had against the debtor. 33 Am Jur 2d *Guaranty* §127. Had plaintiff paid Arizona Sand and Rock pursuant to her guaranty, she would presumably have been entitled to its rights to the contract proceeds.

the assignment of the proceeds.[6] See 4 A. Corbin, *Contracts* § 902.

Pursuant to Rule 58 and Rule 54(b) Federal Rules of Civil Procedure, the parties shall prepare a form of judgment consistent with the views expressed herein and shall submit it to the Court no later than September 18, 1972.

DATED this 31st day of August, 1973.

/s/ Walter E. Craig
UNITED STATES DISTRICT JUDGE

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[6] In addition, the Court is of the opinion that the language contained in the General Indemnity Agreement dated June 1, 1965, is ineffective as an assignment of the proceeds of the four improvement district contracts in Civ. 6056.

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MARTHA MAYTAG DANNERBECK,
Plaintiff-Appellee,

vs.

OSCAR C. PALMER, SR., and CORINNE E. PALMER, his wife; AL A. MARTH, Trustee in Bankruptcy of Pete Horner Excavating, Inc.; CITY OF PHOENIX, a municipal corporation; and CITY OF PRESCOTT, a municipal corporation,
Defendants,

AL A. MARTH, Trustee in Bankruptcy of Pete Horner Excavating, Inc.,
Defendant-Appellant.

No. 72-3201

OPINION

[July 17, 1974]

Appeal from the United States District Court
for the District of Arizona

Before: HAMLEY, MERRILL and WRIGHT, Circuit Judges

HAMLEY, Circuit Judge:

Al A. Marth, Trustee in Bankruptcy of Pete Horner Excavating, Inc. (Horner Excavating) appeals from a declaratory judgment in this diversity action in favor of Martha Maytag Dannerbeck and Oscar C. and Corinne E. Palmer, husband and wife. We affirm.

Initially, two actions for declaratory relief were filed, one by United States Fidelity and Guaranty Company (USF&G) and the other by National Union Fire Insurance Company of Pittsburgh, Pennsylvania (National Union). These plaintiffs, as sureties for Horner Excavating, a bankrupt contractor which had defaulted on city street contracts, sought a declaratory judgment that plaintiffs were entitled to receive the proceeds of six city

improvement district contracts to the extent they had paid to complete the contracts under performance bonds and had paid claims of laborers and materialmen under payment bonds.

The plaintiff surety companies named, as defendants, Oscar Palmer and Mrs. Palmer, the Arizona municipalities of Phoenix and Prescott, and Marth, the contractor's Trustee in Bankruptcy. Palmer had advanced monies to the contractor and claimed the contract proceeds by virtue of assignments. The named municipalities had entered into contracts with Horner Excavating to perform the street contracts in question.

The defendant cities asserted no right to the contract proceeds. Pursuant to stipulation, those proceeds, consisting of cash and municipal bonds, were deposited with a bank in Phoenix to be invested and abide the outcome of the litigation. When it was revealed by pretrial discovery that Mrs. Dannerbeck, as idemnitor, had paid both sureties the full amount of her indemnity obligation, she was, pursuant to stipulation and order, substituted as plaintiff in each action. She then sought, as subrogee of the surety companies, to recover the proceeds of the city street improvement contracts to the extent she had paid the surety companies. Subsequently, the two actions were consolidated.

After extensive pretrial proceedings, Mrs. Dannerbeck, Palmer and the trustee each moved for summary judgment. The result was entry of a declaratory judgment to the effect that Mrs. Dannerbeck was entitled to first priority in and to the funds, that Palmer was entitled to first priority in and to the balance of the funds, and that the trustee was not entitled to any of the funds. At all times the combined claims of Mrs. Dannerbeck and Palmer exceeded the funds in question. Only the Trustee has appealed.

The trustee advances separate arguments against Mrs. Dannerbeck and Palmer, and also contends that the district court was without jurisdiction in this plenary suit based on diversity of citizenship, because exclusive jurisdiction over the claims of Mrs. Dannerbeck and Palmer rested in the bankruptcy court. Ordinarily we give first attention to jurisdictional challenges. However, this particular jurisdictional issue is premised on a factual background which can best be developed by first discussing the other issues.

Martha Dannerbeck's right of subrogation

With regard to Mrs. Dannerbeck's right to the contract proceeds, the trustee advances three arguments. The first two of these arguments are related, and will be considered together. They are: (1) the equities of the case do not favor the right of subrogation being given to Mrs. Dannerbeck, and (2) the equitable right of subrogation will arise in a surety only in the event of loss and it is a right that will not carry over to one who indemnifies a surety when such indemnitor is also a principal and in fact made payment in place of the surety.

The total contract proceeds available aggregated $579,137.42. Of this sum Mrs. Dannerbeck claimed $405,969.56, comprised of the following items: $323,375.32 of the improvement district proceeds under equitable subrogation on a job by job basis, $81,686.00 paid by National Union on two gas tax jobs, and $908.24 paid to USF&G on the Contractor's License Bond by subrogation to the sureties' positions under the assignments in the Indemnity Agreements.

The trustee concedes that if the two surety companies had themselves made good the defaults of Horner Excavating, without indemnification, they would then have been entitled to recover their expenditures from the proceeds of the various contracts.[1] The trustee also recognizes the general equitable principle that an indemnitor is entitled to be subrogated to the rights of a surety.[2] However, the trustee asserts that the foregoing principle does not apply under the circumstances of the case now before us.

The circumstances upon which the trustee relies are as follows: In October of 1963, Martha Dannerbeck's cousin, Pete Horner,

[1]*See Perlman v. Reliance Insurance Company,* 371 U.S. 132 (1962); *Henningsen v. U. S. Fidelity and Guaranty Co.,* 208 U.S. 404 (1908); *Prairie State Bank v. United States,* 164 U.S. 227 (1896).

[2]*See generally Reid v. Pauley,* 121 Fed. 652 (9th Cir. 1903); *Massachusetts Bonding and Insurance Company v. Osborne,* 233 Cal.App.2d 648, 43 Cal.Rptr. 761 (1965); *Westerhold v. Carroll,* 419 S.W.2d 73 (Mo. 1967); *Longview School District No. 112 of Cowlitz County v. Stubbs Electric Co.,* 160 Wash. 465, 295 Pac. 186 (1931); *Stubbs Electric Co. v. Longview School District No. 112 of Cowlitz County,* 153 Wash. 33, 279 Pac. 86 (1929); 11 APPLEMAN, INSURANCE LAW AND PRACTICE § 6683 (1944).

and her husband, Jon L. Dannerbeck, formed a partnership, and in April, 1964, they decided to incorporate. Horner put into the corporation his two pieces of equipment which he valued at from twelve to fourteen thousand dollars, and received twelve to fourteen thousand shares of corporate stock. Jon L. Dannerbeck told his wife his participation would be six thousand dollars and she wrote him a check in that amount which was deposited in their joint bank account. He then wrote a check on that account in the amount of six thousand dollars, paid it to the corporation, and received approximately six thousand shares of stock.

Upon incorporation of Horner Excavating, Horner became President-Treasurer and Dannerbeck became Vice President-Secretary of the corporation. Both were made directors of the corporation. There was no further infusion of equity capital into the corporation, although thereafter it entered into contracts having an aggregate value of about one million dollars.

The statutes then in force in Arizona required any general contractor on improvement district contracts to post, as a condition of his contract, two bonds. One of these was to be conditioned upon the faithful performance of the contract in a sum not less than one-fourth of the contract price. The other was to be for the benefit of all persons who may have claims against the contractor or subcontractor for labor, materials or services used in the work, in a sum not less than one-half of the total amount of the contract.

Of the six improvement district contracts in question, two were bonded by USF&G and the remaining four were bonded by National Union. It was for the purpose of obtaining these surety bonds that Mrs. Dannerbeck, along with her husband, Horner and the corporation, executed the joint and several indemnity agreements in question. Mrs. Dannerbeck testified that her purpose in executing the agreement was to assist the place where her husband was employed and "to assist Jon in getting along in the business he was in."[3]

The Dannerbecks' association with the corporation continued up to late 1965. Jon Dannerbeck resigned as a corporate officer and director on December 3, 1965, and sold his stock to Pete Horner. Thereafter, and while the indemnity agreements in question were

[3]All testimony referred to in this opinion was given by deposition.

in full effect, Horner Excavating defaulted on all of the contracts in question by failing to pay laborers and materialmen and by failing to complete work on three of the contracts. Horner Excavating was adjudicated a bankrupt on July 8, 1966. Thereafter, the Dannerbecks, through their attorney, from time to time settled the amounts of the various claims covered by the surety and indemnity agreements, and sent trust checks signed by the attorney to the surety companies which, in turn, issued their checks in the same amount to the claimants. These payments by the Dannerbecks were made from a joint trust account established by the Dannerbecks, but to which Mrs. Dannerbeck made the sole contribution from her separate property.

The circumstances described above, the trustee asserts, demonstrate that: (1) the corporation, in which Mrs. Dannerbeck had a community property interest, was grossly undercapitalized; (2) Mrs. Dannerbeck's indemnity agreement was therefore, in effect, a contribution to capital, for the purpose of furthering Mrs. Dannerbeck's interest in the corporation; (3) it was thus the power of the Dannerbeck name and property that allowed the massive indebtedness to accumulate against the minimal financing of Horner Excavating; and (4) the described method of paying the claims, whereby the surety companies did not make payouts until they had received checks from the joint trust account corroborates the fact that Mrs. Dannerbeck was acting as a principal and not as an independent indemnitor.

Premised on these circumstances, the trustee calls for application of the principle announced in *Wood v. Steele*, 73 U.S. 80, 82 (1867), that

> ". . . where one of two innocent persons must suffer, he who has put it in the power of another to do the wrong, must bear the loss, . . ."[4]

The trustee finds a parallel between this case and *Braddy v. Randolph*, 352 F.2d 80 (4th Cir. 1965). In that case the court rejected the claims of a person who was a principal stockholder, director and president of a bankrupt corporation, based on four

[4] *See also National Savings Bank v. Cresswell*, 100 U.S. 630, 643 (1879); *Carpenter v. Longan*, 83 U.S. 271, 273 (1872); *Bolivar Reorganized School District No. 1 v. American Surety Company of New York*, 307 S.W.2d 405, 410 (Mo., 1957).

secured notes issued to him by the corporation for money "loaned" to the corporation. The claims were rejected on the ground that the "loans" were actually contributions to the capital of the bankrupt which had been undercapitalized from its inception. Said the court:

> "Rather than invest more capital the officers and stockholders, by the use of the borrowed funds, substantially shifted and evaded the ordinary financial risks connected with this type of business enterprise and, at the same time, permitted the corporation to remain in a constant state of or in imminent danger of insolvency." (352 F.2d at 82.)

The trustee also argues that the equitable right of subrogation is not available to an indemnitor who is also a principal and in fact made payment in place of the surety. In this connection the trustee cites 50 Am.Jur., Subrogation § 20, at 695, for the proposition that

> "The excluded classes are composed of those who discharge debts upon which their liability is primary. . . ."

Pointing out that subrogation is a creature of equity not dependent on contract but upon the equities of the parties, the trustee asserts that to allow subrogation under the facts and circumstances of this case would do violence to equity and rather than promote justice it would work an injustice to the general creditors.

The foregoing, which describes the trustee's contentions in summary form, omitting some supporting arguments and authorities, presents a rather persuasive argument for denial of the right of subrogation to Mrs. Dannerbeck.

But there are countervailing circumstances and arguments which must also be considered. Unlike the claimant in the *Braddy* case, *supra*, Mrs. Dannerbeck was not a director or officer of the corporation, nor was she even a minority stockholder unless her six thousand dollar payment to Jon so that he could purchase corporate stock was a contribution to community property rather than an outright gift to him. Except for the possibility that she had contributed the six thousand dollars to the community property (a fact not established in the record), her only beneficial

interest in the corporation was her community property interest in Jon's corporate salary.

The construction contract funds to which the trustee is laying claim have never been a part of the bankrupt's estate available to the general creditors. The funds never became due and owing to Horner Excavating because that corporation defaulted in its performance of the contract.

Nor is it established in the record that Horner Excavating's inability to complete the contracts was due to undercapitalization, although the company did have a working capital problem. There may have been any number of other reasons for the default: inexperienced and incompetent management;[5] bids which were too low; unmanageable labor and material problems;[6] involvement with other companies to the disadvantage of Horner Excavating;[7] and accidents.[8] It should also be noted that the

[5]Pete Horner, who headed the contracting company, was only about nineteen years old when the contracting corporation was organized in April, 1964. He had first worked for some construction people for a couple of summers. He entered into the street improvement business on his own less than a year before incorporating the contracting company which bears his name. Initially a backhoe rental concern, this business consisted of doing jobs for different contractors.

At the time Horner and Jon Dannerbeck first entered into a partnership, in October, 1963, Jon was about twenty-five years old and had been going to the University of Wisconsin. He was then unemployed. Horner testified that Jon Dannerbeck wasn't really interested in the company, "had other things going," and was "going on trips and stuff."

The corporation did not get into the improvement district kind of work until about September, 1964. The partnership's business aggregated about sixty thousand dollars prior to the incorporation, and consisted primarily of constructing driveways and excavating.

[6]Pete Horner testified that a strike, and the company's failure to take effective counter measures, got the company into trouble.

[7]Pete Horner testified that the contracting company had a thirty thousand dollar loss when a company they had borrowed from, Union Title, "went down." He also testified that he and two others had been stockholders in See Bee Slurry-Matic, which engaged in street maintenance through the use of asphalt. One of the other stockholders agreed to buy Pete Horner's See Bee stock but he failed to do so and Horner Excavating had to take over that company.

[8]Pete Horner testified that just as Horner Excavating was finishing up a job in Prescott, a wall fell over and killed a little girl "and so

company's financial standing was not entirely dependent upon the indemnity contract, since it received substantial financing through appellee Oscar C. Palmer as described in another section of this opinion.

Unlike the cases cited by the trustee, Mrs. Dannerbeck did not purport to loan money to the corporation. She took no part in the business affairs of the corporation, other than to guarantee certain loans to the corporation and to execute the indemnity agreements. She executed a normal indemnity contract such as surety companies frequently require. Her indemnity agreement was acceptable to the sureties because of her substantial separate property. While the sureties were paid from a joint trust account, the corpus of that trust consisted exclusively of Mrs. Dannerbeck's separate property.

Had the surety companies settled and paid the claims themselves, they could have proceeded against the contract funds as subrogees. Or they could have moved against Mrs. Dannerbeck as indemnitor. The fact that she chose to settle the claims and advance funds to the sureties, in advance of payments by them, does not alter the basic fact that she was discharging an indemnitor's obligation. To hold otherwise would be to exalt form over substance.

Allowing Martha Dannerbeck the right of subrogation does not inflict any injustice on the general creditors because if the labor and material claims had not been paid by the sureties or Martha Dannerbeck, the funds in question would, in any event, not have been available to the general creditors but would have gone directly to the laborers and materialmen. *See Jacobs v. Northeastern Corporation*, 416 Pa. 417, 206 A.2d 49 (1965); *In re Dutcher Construction Corporation*, 378 F.2d 866 (2d Cir. 1967). This might not be an adequate answer to the trustee if it had been definitely shown that Horner Excavating's undercapitalization caused that corporation's defaults under the six street-improvement contracts in question. But, as noted above, no such

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that threw everything into an uproar and there was some lawsuits flying around and some arguments, and it just took a lot of money and a lot of time and finally that got straightened out and the blame was put on the engineer up there."

showing was made and, indeed, it was not shown that a substantial contribution to the corporation's capital by Mrs. Dannerbeck would have satisfied the sureties so that they would not have required the indemnity agreements.

On balance, we conclude that there is no compelling "equity" in favor of the general creditors which calls for disregard of the general rule that an indemnitor who has fulfilled its obligation to a surety pursuant to the indemnity agreement, is subrogated to all rights which the surety has with respect to available funds.[9]

The trustee's third reason why Mrs. Dannerbeck should not be granted the right of subrobation with respect to the funds in question is based on the fact that she did not seek contribution from the co-indemnitors, and particularly Pete Horner. The trustee calls our attention to testimony to the effect that Pete Horner visited the Dannerbecks in 1968 and told them he wanted to pay them what he owed them. According to Mrs. Dannerbeck, Mr. Horner had funds in trust with which this could have been accomplished. Mrs. Dannerbeck, however, did not pursue this avenue of recovery or seek any contribution from her co-indemnitors.

The trustee cites authority to the effect that while each of the co-indemnitors was liable to the sureties for the full amount of the undertaking, as between themselves, each is primarily liable for only a portion of the debt, and thus is entitled to contribution from the co-indemnitors. Accepting this to be a correct statement of the law, the question remains whether a co-indemnitor who has fully discharged his liability to the surety is compelled to seek contribution from his co-indemnitors before he may proceed by way of subrogation, against available funds.

The trustee cites no authority for the proposition that, in these circumstances, an indemnitor who has paid his obligation must proceed first against his co-indemnitors for contribution before pursuing his subrogation rights. Nor have we found any support in the books for such a proposition. As a general rule, and apart from election of remedies problems not presented by the case now before us, a party may pursue any remedy the law gives. *See Abdallah v. Abdallah*, 359 F.2d 170, 174 (3rd Cir. 1966).

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[9] *See* authorities cited in note 2, *supra*.

Accordingly, we hold that Mrs. Dannerbeck is not to be denied her right of subrogation by reason of the fact that she did not first seek contribution from the co-indemnitors.

Oscar Palmer's right to the balance of the contract funds

As before stated, the judgment under review, after adjudicating that Mrs. Dannerbeck is entitled to first priority in and to the available funds, adjudicated that Palmer is entitled to first priority in and to the balance of the funds. The exercise of these two priorities would exhaust the funds and leave nothing for the trustee.

Palmer's claim to the funds is based upon his alleged purchase of the improvement bonds to be issued upon completion of the contracts Horner Excavating had with the cities and improvement districts. Horner Excavating's purpose in selling these bonds to Palmer was to obtain additional financing for completion of its various projects. In each instance the purchase of the bonds took the form of a letter prepared and signed by Palmer and accepted by Horner Excavating. The forms of assignment of the proceeds of the contracts were executed by Horner Excavating in favor of Palmer and were lodged with and acknowledged by the municipalities. The assignments referred to "indebtedness" and provided that "this assignment shall stand as security for all indebtedness."

The trustee asserts that these purchase agreements contain conditions precedent to the obligation of the purchaser to accept the finished article, and that therefore title to the bonds could not pass to Palmer until the conditions had been satisfied. The principal conditions precedent upon which the trustee relies are exemplified by these recitals in the letter agreements:

> "at the time of delivery these bonds are to be accompanied by the final approving opinion of Messrs. Gust, Rosenfeld, Divelbess and Robinette of Phoenix, Arizona."
>
> "If for any reason these bonds are not promptly issued in the regular manner or should the job not be completed in average time required for this size of job, you are to promptly refund the amount we have then advanced to you upon written demand."

The trustee contends that because the job was not completed in the "average time required," and because no "final approving opinion" was issued, these asserted conditions precedent failed, and title to the bonds never passed to Palmer. Therefore, the trustee urges, Horner Excavating's liability to Palmer at the time of bankruptcy was simply to refund the amounts advanced by Palmer. This would place Palmer in the position of an unsecured creditor in the bankruptcy proceedings.[10]

Palmer's response is that the conditions in the contract are simply conditions on Palmer's obligation to accept the bonds. In effect, Palmer retained the option of rejecting the bonds if the conditions were not met, thereby transforming Horner Excavating's obligation into a money debt. It should be noted that such transformation does not occur automatically upon Horner Excavating's failure to meet the conditions specified; rather, it occurs only if the conditions are not met *and* Palmer provides a written demand for return of the funds advanced. The option clearly is Palmer's, and the trustee's argument that the obligation is automatically transformed into a money debt upon failure of the conditions appears to be untenable.

More importantly, the trustee discusses only the language of the letter agreements and virtually ignores the existence of the written assignments of the contract proceeds executed by Horner Excavating and accepted by the municipalities. Although the assignments contain numerous errors with regard to identification of parties, they clearly were effective to transfer to Palmer the right to receive the proceeds of the contracts. The fact that in the letter agreements Palmer reserved the right to reject the bonds would not appear to affect the validity of the assignments.

Palmer correctly points out that an assignment of a debt not yet due is effective if there is an existing contract out of which the debt may arise. *See, e.g., Valley National Bank of Arizona v. Byrne*, 101 Ariz. 363, 419 P.2d 720 (1966). Since the contract proceeds were thus effectively assigned to Palmer, then on the

[10]The trustee believes his contention is strengthened by the fact that the assignments contain this provision:

"This assignment is made as security for the payment of any and all indebtedness. . . ."

However, we question whether the quoted language tends to place Palmer in the position of an unsecured creditor.

date of bankruptcy Horner Excavating had no property interest in the proceeds which could vest in the trustee pursuant to section 70(a) of the Bankruptcy Act.

We therefore hold that the district court did not err in determining that Palmer had first priority in the balance of the funds in question.

District court jurisdiction

The trustee asserts that as soon as pretrial discovery revealed the fact that the surety companies did not pay the claims filed against Horner Excavating until they had first received funds therefor from the Dannerbeecks' joint trust account, he filed a motion challenging the plenary jurisdiction of the district court and asking that the matter be remanded to the bankruptcy court.[11] An additional circumstance relied upon by the trustee in making this argument is that both the Dannerbeecks and Palmer had filed claims in the bankruptcy court thereby, the trustee asserts, consenting to its jurisdiction.[12]

The trustee argues that his consent to be joined in this action when filed by the sureties did not carry over to Mrs. Dannerbeck and that the jurisdiction of the bankruptcy court is exclusive as related to the Dannerbeck and Palmer claims. The trustee calls attention to *Pepper v. Litton*, 308 U.S. 295 (1939), where it was held that in the allowance and disallowance of claims, the col-

[11]Actually, the motion the trustee first filed upon discovering the manner in which the claims had been paid, was an objection to the prosecution of the action by the surety companies, coupled with a motion, in the alternative, to dismiss the complaint on the ground that Mrs. Dannerbeck was the real party in interest, in the event a proper substitution of parties was not made. In that motion the trustee made no contention that exclusive jurisdiction rested in the bankruptcy court. Mrs. Dannerbeck was substituted as the party plaintiff on August 8, 1969, and it was not until September 14, 1971, that the trustee requested, as an alternative to deciding the case on the merits in favor of the trustee, that the matter be remanded to the bankruptcy court for final disposition. Again, there was no contention that the bankruptcy court had exclusive jurisdiction and, in fact, the trustee himself expressed a willingness to have the plenary action proceed, providing that he prevailed.

[12]In support of this latter proposition, the trustee cites *In re Muntz T.V., Inc.*, 225 F.2d 493 (7th Cir. 1955); *In re Barnett*, 12 F.2d 73 (2d Cir. 1926); *Britton v. Western Iowa Co.*, 9 F.2d 488 (8th Cir. 1925).

lection and distribution of the estates of bankrupts, the determination of controversies in relation thereto, and in the rejection in whole or in part of claims previously allowed, the jurisdiction of the bankruptcy court is exclusive.

The *Litton* court was speaking of the administration of bankrupt estates. The proceeds of the contracts here in question were never in the actual or constructive possession of the bankruptcy court because those proceeds were never earned by the bankrupt. This action does not involve the priority of claims filed against a bankrupt's estate, but the title to funds which are not in the possession of the bankruptcy court. Neither Mrs. Dannerbeck nor Palmer consented to having the title to this property tried in the bankruptcy court. As Mrs. Dannerbeck and Palmer point out, the rule to be applied under these circumstances is as stated in *Cline v. Kaplan,* 323 U.S. 97 at 99 (1944):

> "If the property is not in the [bankruptcy] court's possession and a third person asserts a *bona fide* claim adverse to the receiver or trustee in bankruptcy, he has the right to have the merits of his claim adjudicated 'in suits of the ordinary character with the rights and remedies incident thereto.'"

The claims which Mrs. Dannerbeck and Palmer filed in the bankruptcy court were merely contingent claims for amounts due that might not be recovered in the plenary action. The filing of contingent claims of this kind does not amount to a consent to have the bankruptcy court determine the title to property not in its actual or constructive possession. *See In re G. L. Odell Construction Co.,* 119 F.Supp. 578, 581 (D. Col. 1954).

In our opinion, the district court had plenary jurisdiction to entertain this action.

Affirmed.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-448

AL. A. MARTH, as Trustee in Bankruptcy of Pete Horner Excavating, Inc., an Arizona Corporation,

Petitioner,

vs.

MARTHA MAYTAG DANNERBECK, and OSCAR C. PALMER, SR., and CORRINE E. PALMER, his wife,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

Brief for Respondent Dannerbeck in Opposition

By KENNETH J. SHERK
CRAIG R. KEPNER
MOORE & ROMLEY
1600 Arizona Title Building
Phoenix, Arizona 85003
Attorneys for Respondents

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Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

Brief for Respondent Dannerbeck in Opposition

Respondent Martha Maytag Dannerbeck requests that the Petition for Writ of Certiorari in this matter be denied.

OPINIONS BELOW

The unreported opinion of the United States District Court for the District of Arizona appears in the Appendix, page 1A of the Petition for Writ of Certiorari. The opinion of the United States Court of Appeals for the Ninth Circuit affirming the District Court appears in the Appendix, page 10A, of the Petition.

JURISDICTION

The Judgment of the Court of Appeals was entered on July 17, 1974. A petition for rehearing was denied on August 12, 1974. The Petition for Writ of Certiorari was filed on October 16, 1974. This Court has jurisdiction under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

The Petition for Certiorari enumerates six "Questions Presented." Question (1), relating to diversity jurisdiction, was not raised below. Question (2), concerning alleged exclusive bankruptcy court jurisdiction, is not properly before this court because the Bankruptcy Court, by its own order long since final, expressly consented to district court jurisdiction. Question (6) relates only to the respondents Palmer. The remaining questions (3, 4 and 5) are but variations on a single theme, i.e. that it was somehow wrong for one who honored an indemnity obligation to sureties to be subrogated to the undisputed rights of those sureties to funds. Insofar as the respondent Dannerbeck is concerned, the only question before this Court is:

> Was the District Court correct in granting and the Court of Appeals in affirming, judgment that the trustee in bankruptcy had no claim to city street contract funds which: (1) never became due and owing to the bankrupt's estate; and (2) were charged with an equitable lien or prior right in favor of the completing and paying sureties and their indemnitor.

STATUTE INVOLVED

28 U.S.C. 1332.

STATEMENT OF THE CASE

A. Factual Background

This litigation concerns the parties' rights in and to the proceeds of certain city street improvement contracts.

Initially two diversity cases for declaratory relief were filed in July, 1966, by two sureties for Pete Horner Excavating, a bankrupt contractor which had defaulted on the city street contracts. The plaintiffs-sureties, neither of which was a citizen of Arizona, sought a declaratory judgment that they were entitled to receive the contract proceeds to the extent they had paid to complete the contracts under performance bonds and had paid the claims of laborers and materialmen under payment bonds.

The defendants were Arizona citizens Mr. and Mrs. Oscar Palmer, three Arizona cities, and Al Marth, the contractor's trustee in bankruptcy. The Palmers had advanced monies to the contractor and claimed the contract proceeds by virtue of certain assignments. The cities, which had entered into the contracts with Pete Horner Excavating, asserted no claim to the contract proceeds.

After institution of the suits by the sureties, respondent Martha Maytag Dannerbeck (an Arizona citizen), pursuant to written indemnity agreements, reimbursed both sureties the full amount of her indemnity obligation. In November, 1968, she was substituted as plaintiff in each action pursuant to stipulation and order. She continued the actions, as subrogee of the sureties, to recover the proceeds of the city street contracts to the extent she had reimbursed the sureties.

The circumstances leading to Mrs. Dannerbeck executing indemnity agreements in favor of the sureties were as follows: In October 1963, her cousin, Peter Horner, and her husband, Jon Dannerbeck, formed a contracting partnership and in April, 1964, decided to incorporate. Her husband used $6,000 of her money to buy stock in the company and Jon became the corporate vice president and secretary. Pete Horner was president and treasurer.

In order to perform improvement district street contracts for an Arizona municipality, contractors must post performance and payment bonds, A.R.S. § 9-684. For the contracts in question, the sureties issued the bonds but required that Mrs. Dannerbeck (a woman of substantial separate property), along with her husband and Horner, execute indemnity agreements in favor of the sureties. Mrs. Dannerbeck's purpose in executing the indemnity agreements was to assist her husband in the business. She was never a director or officer of the corporation, nor was she a minority stockholder. Her only beneficial interest in the corporation was her community property interest in her husband's corporate salary. She took no part in the business affairs of the corporation. (Court of Appeals Opinion, Petition Appendix pp. 15a-17a).

Pete Horner Excavating financed its construction contracts for the cities by funds supplied by the respondents Palmer in exchange for assignments by Pete Horner Excavating to the Palmers of the city bonds to be issued upon the completion of the contracts.

By fall of 1965, Jon had lost interest in the contracting business and Horner agreed to buy Jon's stock from him. In December of 1965, Jon resigned as an officer and director of the Pete Horner Excavating. It was not until summer of 1966, however, that the Dannerbecks cancelled their indemnity agreements, and by that time the contract defaults had occurred and liability on the indemnity agreements had matured.

B. Court Proceedings Below

After the sureties' suits were filed and before they were reimbursed by Martha Maytag Dannerbeck, the Bankruptcy Court entered its order allowing and permitting petitioner Marth, as trustee, to be named a party in the sureties' suits.

The Trustee filed answers to the complaints and admitted jurisdiction. Furthermore, the trustee admitted that the rights of the sureties were superior to the rights of the Trustee as to the amount of claims for labor and materials which had been paid out under the bonds plus the cost of completing each project.

In December 1968, after her substitution as plaintiff, respondent Dannerbeck filed a second amended complaint in each action seeking the contract proceeds in her own right as indemnitor-subrogee of the sureties. When the Trustee answered the second amended complaint he again admitted that the sureties had an equitable priority in and to the contract proceeds; but he denied that respondent Dannerbeck, as the sureties indemnitor, had the same priority.

On September 14, 1971, for the first time, the Trustee requested, as an alternative to deciding the case on the merits in favor of the Trustee, that the matter be remanded to the Bankruptcy Court for disposition although there was no contention that the Bankruptcy Court had exclusive jurisdiction.

Upon motions for summary judgment by all parties, the District Court ruled that respondent Dannerbeck, as subrogee of the sureties, had a priority claim to the extent she indemnified the sureties for payments made to complete and satisfy labor and material claims on the street contracts. The District Court awarded the balance of the contract proceeds to the respondents Palmers. The District Court denied the Trustee's claim to the proceeds pursuant to *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962) and *In Re Dutcher Construction Corporation*, 378 F.2d 866 (2nd Cir. 1967). Only the Trustee appealed from the judgment of the District Court. The Court of Appeals affirmed the judgment of the District Court.

REASONS FOR DENYING THE WRIT

A. The Lower Courts Properly Analyzed the Facts and Determined Questions of Law That Should Not Be Reviewed Here

This Court will ordinarily deny certiorari, where as here, review is sought of a lower court decision which turns solely upon an analysis of the particular facts involved, or upon the construction of particular contracts or written instruments. *United States v. Johnston*, 268 U.S. 220 (1925); see generally, *R. Stearn & E. Gressman, Supreme Court Practice*, 172 (4th Ed. 1969). As this Court stated in *United States v. Johnston*, 268 U.S. 220, 227 (1925), "we do not grant a certiorari to review evidence and discuss specific facts." This is particularly true when the two courts below have concurred. *Graver Tank & Mfg. Co. v. Linde Air Products Co.*, 336 U.S. 271 (1949) and cases cited therein: *Berenyi v. District Director, Imm. & Nat. Serv.*, 385 U.S. 630 (1967).

Both the District Court and the Court of Appeals properly determined that the construction contract funds to which the Trustee is laying claim never were a part of the bankrupt's estate available to the general creditors. The funds never became due and owing to the bankrupt contractor because it defaulted in its performance of the contract. *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962) and *In Re Dutcher Construction Corporation*, 378 F.2d 866 (2nd Cir. 1967). The Courts further correctly found no compelling equity in favor of the general creditors which would call for disregard of the general rule that an indemnitor who has fulfilled her obligation to a surety, is subrogated to all rights which the surety has with respect to available funds. See, *e.g., Reid v. Pauley*, 121 F. 652 (9th Cir. 1903) and other decisions cited by the Court of Appeals at Petition Appendix 12a, n. 2. In this regard, the Court of Appeals observed that:

"had the surety companies settled and paid the claims themselves, they could have proceeded against the contract funds as subrogees. Or they could have moved against Mrs. Dannerbeck as indemnitor. The fact that *she chose to settle the* claims and advance funds to the sureties, in advance of payments by them, does not alter the basic fact that she was discharging an indemnitor's obligation. To hold otherwise would be to exalt form over substance." (Petition Appendix p. 17a).

The Courts properly found that allowing the indemnitor the right of subrogation did not deprive the general creditors of anything because if the labor and material claims had not been paid by the sureties or their indemnitor, the funds would in any event not have been available to the general creditors but would have gone directly to the laborers and materialmen. *Jacobs v. Northeastern Corporation,* 416 Pa. 417, 206 A.2d 49 (1965); *In Re Dutcher Construction Corporation,* 378 F.2d 866 (2nd Cir. 1967).

With respect to the claim of exclusive bankruptcy jurisdiction raised by the Trustee, the Courts properly rejected the Trustee's argument and reliance on *Pepper v. Litton,* 308 U.S. 295 (1939). In *Pepper v. Litton,* unlike the situation here, the court was speaking of the administration of bankrupt estates. It was undisputed in the case at bar that the contract proceeds were never in actual or constructive possession of the bankrupt contractor because they were never earned by the bankrupt. Consequently, all respondents had an absolute right to have their claims "adjudicated 'in suits of the ordinary character, with the rights and remedies incident thereto.'" *Cline v. Kaplan,* 323 U.S. 97, 99 (1944).

Furthermore, the Courts below properly noted that the Bankruptcy Court entered an order which became final allowing and permitting the Trustee to appear and defend in the plenary actions. The Trustee, in fact, did so appear,

answered the complaints and admitted jurisdiction. As the Court of Appeals perceived, the Trustee never did contend that the Bankruptcy Court had exclusive jurisdiction and, in fact, the Trustee himself expressed the willingness to have the plenary actions proceed, provided that he prevailed. (Petition Appendix, p. 21a, n. 11.).

B. There Is No Conflict of Decisions

Petitioner's assertion that the decision in the instant case is in conflict with decisions of this Court and the circuit courts is totally unsupported. Nowhere has petitioner directed attention to any particular decision of this Court or the circuit courts which is in conflict with the decision in the instant case.

C. Petitioner's Argument as to Lack of Diversity Jurisdiction Is Without Merit

The argument that there was no diversity jurisdiction, raised for the first time in the Petition for Certiorari, is without merit. There is no question but that there was diversity of citizenship at the commencement of the filing of the actions by the sureties. The fact that the respondent Dannerbeck was later substituted as plaintiff in the original actions did not defeat diversity jurisdiction which existed at the commencement of the filing of the suits. As Chief Justice Marshall observed as long ago as 1824:

> "It is quite clear, that the jurisdiction of the court depends upon the state of things at the time of the action brought, and that after vesting, it cannot be ousted by subsequent events."

Mollan v. Torrance, 9 Wheat 537, 6 L.Ed. 154. See also *Clarke v. Mathewson*, 12 Peters 164, 9 L.Ed. 1041 (1838); *Niesz v. Gorsuch*, 295 F.2d 909 (9th Cir. 1961) and *Formulabs, Incorporated v. Hartley Pen Company*, 318 F.2d 485 (9th Cir. 1963).

CONCLUSION

Petitioner has wholly failed to sustain his burden of establishing, under Rule 19, that there are "special and important reasons" why the Writ should be granted. The decision below did not involve an important question of law which has not been, but should be, settled by this Court; nor has the Court of Appeals decided a federal question in a way to conflict with applicable decisions of this Court or of another court of appeals on the same matter. The Court of Appeals correctly held that the findings and judgment of the District Court were proper and so affirmed. It is respectfully submitted that the Petition for Certiorari should be denied.

Respectfully submitted,

MOORE & ROMLEY
KENNETH J. SHERK
CRAIG R. KEPNER
1600 Arizona Title Building
Phoenix, Arizona 85003
Attorneys for Respondents

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Respondents.

REPLY BRIEF ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

HUGHES & HUGHES, P.C.
By John C. Hughes
411 North Central Avenue
Phoenix, Arizona 85004
(602) 252-8001
Attorneys for Petitioner

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Petitioner,

v.

MARTHA MAYTAG DANNERBECK, and OSCAR C. PALMER, Sr., and CORRINE E. PALMER, his wife,

Respondents.

REPLY BRIEF ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

IN THE

Supreme Court of the United States

October Term, 1974

No. 74-448

AL A. MARTH, as Trustee in Bankruptcy of Pete Horner Excavating, Inc., an Arizona Corporation,

Petitioner,

v.

MARTHA MAYTAG DANNERBECK, and OSCAR C. PALMER, Sr., and CORRINE E. PALMER, his wife,

Respondents.

REPLY BRIEF ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The response of the respondent Dannerbeck by inference and half truth attempts to convince the Court that at the time the suit was filed the respective interest of the Dannerbecks and the surety companies were separate and apart and that the sureties were therefore entitled to establish jurisdiction and diversity. The inference and half truth will not stand scrutiny of the record. It was *Mrs. Dannerbeck's* Phoenix attorney that filed the lawsuits naming the surety companies as plaintiffs. And, as is clearly established by letter from Mrs. Dannerbeck's Iowa attorney, Francis C. Miller dated July 26, 1966, a conference call had taken place on *July 22, 1966* in

the course of which the arrangements for the trust account to be opened in Phoenix had been made. *July 22, 1966 was the same date on which the lawsuits had been filed.* The first paragraph of the letter to which we refer reads as follows:

> "In accordance with our conference phone call last Friday, *July 22*, including you and *Ken Sherk* at Phoenix, Frank Sanders at Chicago and myself at Newton, I am enclosing a check drawn on Mrs. Martha Maytag Dannerbeck Investment Account dated July 28, 1966 payable to your firm - Moore, Romley, Kaplan, Robbins & Green - for the sum of $100,000.00, the proceeds of which to be deposited by you in an account out of which you may withdraw to reimburse either of the two bonding companies - *United States Fidelity and Guaranty Co. and National Union Fire Insurance Company of Pittsburgh, Pa.* - for those items for which the *Dannerbecks* are liable under the indemnity agreements executed by them on behalf of Pete Horner Excavating Co."

It is difficult indeed to believe in the face of such record that the respondents can seriously expect this Court to believe that it was the surety companies who were the real parties in interest at the time the lawsuits were instituted. The respondent's brief uses the word "reimburse". However, this also is contrary to the record. Mrs. Dannerbeck never reimbursed the surety companies. She settled the claims and paid them in advance. The part of the sureties in the transactions was merely to go through the motions of appearing to make the payments to create the paper sham for this lawsuit. A classic example of form over substance.

The Dannerbeck representations as to the lack of diversity jurisdiction is equally without merit. Lack of federal jurisdiction cannot be waived or overcome by agreement of the

parties. *Mitchell v. Maurer*, 55 S. Ct. 162, 293 U.S. 237, 79 L. Ed. 338 *and may be raised at any stage of the proceedings. Peale v. Phepps*, 55 U.S. 368, 14 How. 368, 14 L. Ed. 549; *City of Gainesville v. Brown Investment Co.*, 48 S. Ct. 454, 277 U.S. 54, 72 L. Ed. 781, *cert. denied*, 50 S. Ct. 27, 280 U.S. 569, 74 L. Ed. 622; *Matson Nav. Co. v. U.S.*, 52 S. Ct. 162, 284 U.S. 352, 76 L. Ed. 336.

Even if the parties failed to raise the issue or consent that the case be considered on the merits, this Court must still examine and determine if jurisdiction existed. *Metcalf v. Watertown*, 128 U.S. 586.

In *Louisville and Nashville R. R. v. Mottley*, 29 S. Ct. 42, 211 U.S. 149, 53 L. Ed. 126 (1908) this Court said

> "Neither party has questioned that jurisdiction, but *it is the duty of this court to see to it that the jurisdiction of the Circuit Court which is defined and limited by statute, is not exceeded.* This duty we have frequently performed of our own motion. Mansfield & c RR Co. v. Swan, 111 U.S. 379, 382; King Bridge Co. v. Otoe County, 120 U.S. 225; Blacklock v. Small, 127 U.S. 96, 105; Cameron v. Hodges, 127 U.S. 322, 326; Metcalf v. Watertown, 128 U.S. 586, 587; Continental National Bank v. Buford, 191 U.S. 199."

It is true that jurisdiction can depend on the state of things at the time the action is brought. But, this is assuming that there is no misrepresentation or feigned allegations made solely for the purposes of establishing jurisdiction. *England Builders, Inc. v. Shea*, 359 F.2d 927 (10th Cir.). Here it was established that Mrs. Dannerbeck was the real party in interest at the time the lawsuit was filed. However, there was no mention of her in the original Complaints or that the actions were being filed under the express trust and on her behalf. If there had been, clearly objection could have been

raised at that time. The citizenship of the real party in interest is the governing factor. There was no change in the situation subsequent to the lawsuit being filed. Mrs. Dannerbeck's position was simply an undisclosed factor. We submit therefore that the consent of the Bankruptcy Court having been obtained through misinformation and nondisclosure to the Bankruptcy Court, and diversity jurisdiction having been established by feigned allegations, the judgment of the lower courts must be set aside for lack of jurisdiction.

We are not, as is contended, in the response, asking the court to review a factual situation. There is little or no dispute on the facts. What we are asking is that this Court review what we believe to be a decision which seriously conflicts with the established law. We do not believe that the law will allow a principal in a closely held corporation to profit at the expense of the general creditors without proving the claim in the Bankruptcy Court.

The respondent further calls for an application of a rule of law that an indemnitor who has fulfilled his obligation to a surety is entitled to subrogation. However, the rule of law as shown by the decision cited in the Ninth Circuit opinion only allows an innocent indemnitor to pursue the ultimate wrongdoer so that the loss is borne by the one responsible for creating it. In this case, Mrs. Dannerbeck is one of the persons responsible for the loss. She is not an innocent third party but a major figurehead in the financing structure of the corporation and a community stockholder. *Her indemnity contract with the surety did not provide for any subrogation rights whatsoever.* In fact it had her warrant that she was a principal for whom the suretyship was given. If she is a principal she is not entitled to subrogation.

The argument as to the contract funds never becoming a part of the bankrupt estate has been raised again and again and again, but there has never been authority cited or argument raised against the proposition that if there had been a surplus it would have belonged to the estate. *Marks v. Brucker*, 434 F.2d 897 (9th Cir. 1972); *In re Community Neighbors, Inc.*, 287 F.2d 572 (7th Cir. 1961); 3 *Collier on Bankruptcy*, 14th Ed. 57.17. If Mrs. Dannerbeck's claim had been denied there would have been a surplus. What we have apparently never been able to convince the courts below is that if Mrs. Dannerbeck had put her money where her paper was, *i.e.*, backing the corporation, the situation may never have arisen and even if it had she never would have been given a place ahead of the general creditors. *Pepper v. Litton*, 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281, would have been surely applicable as also *Braddy v. Randolph*, 352 F.2d 81 and the other cases cited in the Petition.

CONCLUSION:

There are special and important reasons why this Writ should be granted. The decision on its face creates bad law which can only lead to confusion in bankruptcy and we respectfully submit that the Writ of Certiorari should issue.

HUGHES & HUGHES, P.C.

By John C. Hughes
Attorneys for Petitioner

November, 1974.

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